STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

PROPOSED DECISION

JANUARY 1, 2009 WORKERS' COMPENSATION PURE PREMIUM RATES

FILE NUMBER REG-2008-00027

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **January 1, 2009**.

EXPLANATION AND HISTORY

A public hearing in the above captioned matter was held on September 16, 2008 at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2008-00027 dated August 15, 2008, which is included in the record. At the conclusion of that hearing, and as noticed in the Notice of Proposed Action and Notice of Public Hearing, the hearing officer announced that the record would be kept open for additional written comment until 5:00 p.m. on Tuesday, September 23, 2008. The record was closed at 5:00 p.m. on September 23, 2008.

The record discloses the persons and entities to whom or which the Notices were disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted by the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated August 15, 2008 submitted by the Workers' Compensation Insurance Rating Bureau of California (WCIRB) and related documents were available for inspection by the public at the Sacramento office of the Department of Insurance and were available online at the WCIRB website, www.wcirbonline.org.

The WCIRB's filings proposed Pure Premium Rates that reflect insurer loss costs and loss adjustment expenses and adjustments to the California Workers' Compensation Experience Rating Plan—1995 to conform to the proposed Pure Premium Rates. In addition, the WCIRB has proposed amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and California Workers' Compensation Experience Rating Plan—1995.

Testimony, written and oral, was taken at a hearing in San Francisco on September 16, 2008 and exhibits were received into the record. Additional documentation requested by the hearing panel was submitted subsequent to the hearing but prior to the close of the time period to receive written comment along with correspondence and documents submitted by the public. The matter was submitted for decision at the conclusion of the period to receive written comment on September 23, 2008. The matter having been duly heard and considered, the following Proposed Decision and Proposed Order are hereby made.

WORKERS' COMPENSATION ADVISORY PURE PREMIUM RATE AS A CLAIMS COST BENCHMARK

Based upon the statements provided in these proceedings, there appears to be a misconception regarding the Insurance Commissioner's decision regarding the advisory pure premium rate and the premiums charged by insurers to employers. Some clarification and explanation regarding this subject is needed, as well as a change in terms used in this proceeding.

Subdivision (b) of California Insurance Code Section 11750 states that the Insurance Commissioner shall hold a public hearing within 60 days of receiving an advisory pure premium rate filing made by a rating organization pursuant to subdivision (b) of Insurance Code Section 11750.3 and either approve, disapprove, or modify the proposed rate. Subdivision (b) of Section 11750.3 states that a rating organization, such as the WCIRB, shall collect and tabulate information and statistics for the purpose of developing pure premium rates to be submitted to the Commissioner. No further directions or guidance is given in California law concerning the pure premium rate or rates.

The WCIRB has developed a classification system whereby various occupations or industries are classified for the purpose of developing the statistical information concerning the losses due to work injuries as well as developing the prospective estimate of the cost of losses and loss adjustment expenses per hundred dollars of payroll in each of those classifications. The cost of losses consists of the amounts to be paid in indemnity and medical benefits, and also includes the expenses to adjust those claims. These are known as "loss costs" or are better known as "pure premium rates." However, the pure premium rates are not the rates filed by insurers or the premiums charged to employers, thus adding to possible confusion.

The WCIRB presents to the commissioner for his or her approval the overall average increase or decrease of the pure premium rates based upon its review of the entire claims costs in the workers' compensation system, which is known as the advisory pure premium rate. It will then apply the approved change to the various classifications based upon the relativities between each classification to make sure the entire average cost does not exceed the approved change.

The explanation of this process can be confusing both by the terms and its complexity. However, this confusion may be lessened by simply referring to the current approved level of claims costs in the system as a benchmark and then specifying the increase or decrease. Therefore, the advisory pure premium rate will be referred to in this Proposed Decision and henceforth as the Workers' Compensation Claims Cost Benchmark or Claims Cost Benchmark.

The Claims Cost Benchmark approved by the Insurance Commissioner reflects only loss costs; it does not include any provision for general expenses, commissions, other acquisition expenses, premium taxes, or profits. These are accounted for in the rates filed by workers' compensation insurance companies.

The Claims Cost Benchmark is advisory only and is an actuarial measure of the minimum required to cover those loss costs and do not reflect the actual premiums that insurers may charge employers. The law does not require insurers to adopt the Claims Cost Benchmark or its adjustment, and insurers may file rates as they deem appropriate so long as they are in compliance with the California Insurance Code and associated regulations and are neither discriminatory nor affect an insurer's financial solvency. The California workers' compensation rate laws do not limit the profit a workers' compensation insurance company may make.

The change to the Claims Cost Benchmark proposed by the WCIRB in its August 15, 2008 filing is 16.0% higher (+16.0%) than the current level. In a supplemental filing dated September 12, 2008, the WCIRB noted that with its Accident Year Experience valued as of June 30, 2008, the Claims Cost Benchmark could be increased by 16.4%, but the additional 0.4%, being such a small amount, did not warrant amending the proposed 16% increase. However, it was noted that medical losses increased substantially and would have resulted in a much larger increase except for the fact that medical loss development for the State Compensation Insurance Fund (SCIF) was excluded from the analysis due to late payments of medical billings.

It was also noted in both the original and amended filings of the WCIRB that changes to the permanent disability rating schedule were pending and would possibly cause further increase in the Claims Cost Benchmark. It was stated at hearing that when changes to the permanent disability rating schedule do occur, a separate hearing will be conducted after an appropriate filing by the WCIRB. Since that hearing, it is noted that one of the proposed changes, Senate Bill No. 1717 (Perata), was vetoed by Governor Schwarzenegger and will not go into effect.

The Department of Insurance staff proposes the Insurance Commissioner adopt a change in the Workers' Compensation Claims Cost Benchmark that is 9.4% higher (+9.4%) than the current level. The change in the Claims Cost Benchmark adopted herein is based upon the hearing testimony and an examination of all materials in the record by the hearing panel, which included two of the Department's senior actuaries, Ronald Dahlquist and Eric Johnson, who prepared the analysis and conclusion regarding the change to the Claims Cost Benchmark, set forth below.

ACTUARIAL DISCUSSION AND RECOMMENDATION

Trending of the Indemnity On-Level Loss Ratio

Previous WCIRB filings have calculated the projected indemnity loss to pure premium ratio by averaging of the loss ratios for the two most recent accident years and applying no trend going forward. That method is unchanged in this filing.

Frank Neuhauser, project director of the UC DATA/Survey Research Center, provided oral and written testimony, raising issues about the indemnity frequency and severity trends. The WCIRB does not make any explicit assumptions about separate indemnity frequency and severity trends. Instead they consider the pure premium trend, which combines the two. The selection of a zero pure premium trend implicitly assumes that a frequency decrease offsets the severity increase. The WCIRB's benefit-frequency regression model calculates a residual frequency decrease of 2% a year.

To argue for a lower frequency trend, Mr. Neuhauser pointed to the long-range trends in the WCIRB data. He also cited data from the Bureau of Labor Statistics, the Division of Workers Compensation and the Office of State Health Planning & Development.

For severity trend, Mr. Neuhauser considered each indemnity benefit type separately. He said that temporary and permanent total benefits would track wage inflation, but permanent partial benefits would increase more slowly because of the effect of the minimum and maximum benefit caps. He also pointed to various statistics showing a decrease in duration in temporary disability and evidence that the severity of permanent partial disability ratings is not changing and that the frequency is decreasing. He said permanent total disability claims were dropping in frequency more than indemnity claims in general and that the increase in severity was a one-time event due to the reforms.

We do not find Mr. Neuhauser's argument about indemnity frequency compelling. The recent large decrease is clearly the result of the reforms. As the decrease is a one-time event, it is inappropriate to project it into the future. The data from alternative sources significantly overlaps and is driven by the same factors as the WCIRB data. Thus the alternatives are also affected by the reforms. We do not see any evidence that makes us question the WCIRB's benefit-frequency regression model.

We are also not convinced by Mr. Neuhauser's argument about severity. The difference between wage inflation and increased benefits due to wage inflation is already factored into the on-level calculation. Mr. Neuhauser says that the mix of injuries has changed toward less serious injuries, but that assertion appears to contradict the data provided by the WCIRB, which shows death and permanent total disability claims increasing from 2005 to 2006 by 2% of the total and a corresponding decrease in permanent partial disability claims. Therefore we approve the method employed by the WCIRB.

Trending of the Medical On-Level Loss Ratio

Previous WCIRB filings have calculated the projected medical loss to pure premium ratio by trending forward the average of the loss ratios for the two most recent accident years at a rate of 1% a year. In this filing, the WCIRB has increased the rate from 1% a year to 5% a year. The trend period is three years, so the total amount of trend increases from 3% to 16% (not 15%, due to compounding). The increase in the trend adds 8.7% to the indicated pure premium, thus accounting for more than half of the amount requested.

The WCIRB says there is clear evidence of increase in the average medical cost per claim since 2004. The on-level ratio increased 12% in accident year 2006 over 2005 and 6% in 2007 over 2006. Taking into account the frequency declines of -8.2% and -5.4%, respectively, the pure premium increases translate into severity increases of 22% and 12%. The WCIRB says that the selected 5% is "generally consistent with long-term pre-reform overall medical loss trend in California (5%), recent post-reform medical loss trend in California (7%) and the long-term medical trend in other states (4%)."

The WCIRB cites a California Workers Compensation Institute (CWCI) analysis showing an increase in surgery costs and a CWCI preliminary study showing significant increases in payments per claim for accident year 2006. The WCIRB also points to treatment for chronic pain, medical cost containment, medical-legal reports, and compromise and release settlements.

In a letter dated September 23, the WCIRB responded to various questions asked by the hearing panel. On the issue of medical loss trend, the panel had asked the WCIRB to quantify the individual impacts of the five factors the WCIRB cited. The 11% increase in medical treatment costs between 2005 and 2006, derived from the CWCI data, has an 8% impact on total medical costs. The 20% increased cost in compromise and release settlements between 2004 and 2005, the latest year available, translates into a 3% increase in total medical costs. The 16% increase in medical cost containment translates into a 1% increase in total medical costs. Because the costs of medical-legal are only 4% of total medical costs, the impact is relatively small The WCIRB is not able to establish a number for chronic pain management.

Mr. Neuhauser said that over 1/3rd of the increase in total medical losses can be attributed to medical cost containment expenses and these are not likely to continue increasing. Medical cost containment as a fraction of medical costs increased from 5.7% in 2002 to more than 11% in 2007. He said that the change in medical-legal costs is explained almost entirely by the Official Medical-Legal Fee Schedule that was effective for service dates on or after July 1, 2006, a one-time event. In addition, an increase in evaluation & management reimbursement effective February 15, 2007, which added 3.53% to medical costs, was also a one-time event.

Mr. Neuhauser also criticized the CWCI studies, saying that the data have a substantial bias because the sample is dominated by SCIF claims.

Mark Gerlach, representing the California Applicants Attorneys Association, gave testimony at the hearing. He said that there was little medical treatment provided in 2004, so the increase in 2005 and 2006 will not continue into 2009-11. He also said that insurers are using their recent profits to close out claims on older years, thus accounting for the increase in costs on stipulations. He said that there has been an increase in medical/legal costs as issues such as apportionment are being sorted out, but that costs are not likely to continue to increase in the future. He also said that the WCIRB has not revised its initial estimate of the savings from apportionment and other changes such as the permanent disability rating schedule and the treating physician presumption.

We reject the WCIRB's selection of a 5% a year trend for the on-level medical to pure premium ratio. We substitute a 3% pure premium trend, equivalent to a 5% severity trend. The result, all other things being equal, is a 4.5% decrease in the indicated pure premium change.

We give credence to the arguments made by both Mr. Neuhauser and Mr. Gerlach that the increases from 2005 to 2007 are temporary in nature. That the change from 2006 to 2007 is significantly smaller than the change from 2005 to 2006 suggests that this is so. The 5% selected pure premium trend, along with the implicit 2% frequency trend, results in a 7% severity trend. This is slightly higher than that shown in the medical cost component of the Consumer Price Index, which also measures severity. No reforms will be 100% effective and participants in the system will always find ways to do better for themselves.

However, it is unreasonable to assume, as the WCIRB implicitly does, that medical utilization guidelines, employer-controlled medical provider networks and mostly-frozen fee schedules have minimal or no dampening effect on costs. Calculating a specific number is difficult, if not impossible, given the sweeping changes and the uncertainty about when or even whether the system has stabilized. Thus we are inevitably forced to rely on judgment. We believe a 3% trend is a temperate, conservative, reasonable judgment.

We are not convinced by Mr. Neuhauser's argument that the CWCI ICIS data is a biased sample. We believe this data can give us valuable insight. As a side note, we believe this data would be more valuable if it were timely. Having more data on accident year 2007 would be very helpful. The CWCI analysis presented at the hearing uses an unusual method of data aggregation, comparing each individual claim at a particular age, rather than an entire accident year at a particular valuation date. The latter aggregation method is what the WCIRB uses in its filing and is nearly universal in actuarial work. While it does have the weakness of combining claims at different ages, the strength of having more current information more than makes up for it. We encourage the CWCI to consider expanding its analyses to include such an aggregation.

Loss Adjustment Expense

We pointed out in the Proposed Decision on the January 1, 2008 filing that the industry Loss Adjustment Expense (LAE) experience was distorted by SCIF's data.

Specifically, SCIF has had a problem with excess staffing in its claims function for the last two years. This problem was caused by its need to staff up to meet the workload associated with its 50% market share in recent years, followed by its recent decline in market share to 20%. SCIF has been unable to reduce its claims staff as rapidly as its market share and premium volume has decreased.

In recognition of this problem, we disallowed the use of SCIF's LAE experience in the last filing, and instead substituted an LAE provision based solely on Private Insurer experience. We did this because we identified an element of excess expense in SCIF's experience that was not related to the cost of adjusting claims and could not reasonably be expected to be related to the prospective cost of adjusting claims. The current WCIRB filing recognizes the existence of this problem, but seeks a compromise of sorts by giving SCIF's LAE experience 50% of its normal weight based on its historical share of the experience by accident year.

Additionally, we point out that SCIF's LAE level as a percentage of loss appears to have been about the same as that of the private insurers until the last two years. Table 4 on Page A:B-136 of the WCIRB's original filing submission provides a comparison of these ratios for SCIF and for the private insurers. While it is obvious that SCIF and the private insurers have significantly different levels of both Unallocated Loss Adjustment Expense (ULAE) and Allocated Loss Adjustment Expense (ALAE), it is also true that the total LAE as a percentage of loss is very similar until very recently.

The comparison by calendar year is as follows. For calendar year 2002, the sum of the ULAE and ALAE percentages to loss for SCIF was 11.3%, while it was 13.9% for the private insurers. For calendar year 2003, SCIF's total LAE percentage was 14.5%, while it was 13.0% for the private insurers. For calendar year 2004, SCIF's ratio was 15.8%, while the private insurers' ratio was 18.4%. For 2005, SCIF's ratio was 20.9%, while the private insurers' ratio was 20.7%. The differences were as follows: for 2002, SCIF's ratio was 2.6% lower than the private insurer ratio; for 2003, it was 1.5% higher; for 2004, it was 2.6% lower, and for 2005, it was 0.2% higher. On average, it appears that SCIF's LAE percentage to loss was slightly lower than that of private insurers over this time period.

In 2006, SCIF's percentage of LAE to loss was 31.7%, as compared to 29.9% for the private insurers. SCIF's ratio was 1.8% higher. This is still within the range of the prior years' ratios from 2002 through 2005, but higher than in 2005.

The latest year is an entirely different matter, however. In 2007, SCIF's ratio increased significantly to 38.4%, while the private insurers' ratio declined to 22.2%. SCIF's ratio is suddenly 16.2% higher than that of the private insurers, a result that is obviously far out of line with recent historical experience.

We reject the WCIRB approach of allowing the SCIF LAE experience to be used on a tempered basis in determining the overall LAE provision, and once again require that the LAE provision be based exclusively on private insurer experience, with no weight given to SCIF's experience. We base this decision on the same reasoning as we did in the last filing, and point to the calendar year ratio comparisons as a demonstration of the inappropriateness of including SCIF data.

In keeping with this decision, the following discussions are based on our review of the WCIRB's analysis of private insurer LAE experience.

ALAE

The WCIRB ALAE provision of 14.6% of loss is based on the paid ALAE development method using the latest year ALAE development and estimated growth in ALAE per indemnity claim. This is also based on including SCIF experience at half its historical weight by accident year.

We agree with the appropriateness of the method chosen by the WCIRB, with two exceptions. The first, the inclusion of SCIF data, has been discussed. The second has to do with the trending of the average ALAE per claim. The WCIRB trends the average ALAE per claim by applying the changes in forecast values of the average annual wage for the Professional and Technical component of the Consumer Price Index. We assume that the rationale for using a CPI wage change component for this purpose is that the historical changes in the average ALAE per claim are too volatile in recent years to allow the use of observed changes in the average ALAE per claim, and that this CPI component is the best available alternative. While we think the relationship between changes in ALAE and changes in the CPI wage component is likely to be less than perfectly correlated, we agree that the historical changes in average ALAE per claim are of limited value. We accept the Bureau's method with one change: we include a 1% per year productivity offset to the CPI wage trend. We are of the opinion that such an offset is appropriate, since insurers can be expected to make efforts to increase the productivity of all of their operations.

Finally, we need to adjust our ratio of ALAE to loss for the fact that our loss provision is lower than the Bureau's. The end result is that we approve an ALAE provision of 15.0% of loss.

ULAE

The WCIRB bases its ULAE provision of 11.3% on the average of the new "ULAE per Open Claim" method and the "Ratio to Paid Losses" method. This is also based on including SCIF experience at half its historical weight by calendar year.

As has previously been explained, we do not agree with the inclusion of any of SCIF's LAE data. We also believe there is merit in the new "ULAE per Weighted Open Claim" method that was presented by the WCIRB but was not given any weight in their selected provision. The method is explained in the filing and is very similar to the "ULAE per Open Claim" method.

Starting with the Bureau's application of the new "ULAE per Open Claim" and "ULAE per Weighted Open Claim" methods to the private insurer data, we make only one change: we include a 1% per year productivity offset. This is done in the same manner and for the same reasons we made the modification to the Bureau's selected ALAE method.

There are two pertinent comments to be made about these methods as they have been applied to the private insurer data.

The first is that the logical connection between ULAE expense trends and CPI wage trends seems to be stronger than does the logical connection between CPI wage trends and ALAE expense trends. ULAE is primarily salary expense, so it is easy to conclude that wage inflation is likely to be the primary influence on these costs. ALAE, on the other hand, has a major component of attorneys' fees, so wage inflation should be only one of a number of influences on ALAE cost trends.

The second is that the data on average ULAE per open claim and average ULAE per weighted open claim both appear as step functions, rather than showing distinct trends over time. For example, the "ULAE per Open Claim" method is presented on page 26 of the Bureau's amended filing, dated September 12. Column (b) of the exhibit shows the average ULAE incurred per open indemnity claim. A cursory examination of the values in this column seems to show that the values for calendar years 2003 and 2004 are much higher than both the values for the pre-reform calendar years 2000, 2001, and 2002 and the values for the post-reform years 2005, 2006, and 2007. It is hard to say whether or not there is a discernible trend in the values for the latter three years. Despite this, we believe it is a reasonable long-term expectation that ULAE will increase over time due to wage inflation. We also believe it is appropriate to include an offset for productivity gains.

The results of both these methods are adjusted to take into account the fact that we have selected a lower ultimate loss ratio, thus reducing the denominator in the ratio of ULAE to loss.

We accept the WCIRB's "Ratio to Paid Losses" method as is, but adjust it to recognize our lower selected loss ratio, as we have for the other ULAE methods and the ALAE method. We base our selected ULAE provision on a weighted average of the "ULAE per Open Claim" method, the "ULAE per Weighted Open Claim" method, and the "Ratio to Paid Losses" method. We give 25% weight to each of the first two methods, and 50% weight to the third method. Finally, we need to adjust our ratio of ULAE to loss for the fact that our loss provision is lower than the Bureau's. The end result is that we approve a ULAE provision of 9.0% of loss.

Loss Adjustment Expense Multiplier

As detailed above, we approve an ALAE provision of 15.0% of loss and a ULAE provision of 9.0% of loss, for a combined loss adjustment expense provision of 24.0% of loss, instead of the WCIRB provision of 25.9% of loss. The resulting approved loss adjustment expense multiplier is 1.240.

Experience Rating Off-Balance Factor

In the prior filing, the WCIRB requested a change in the experience rating off-balance factor from 1.030 to 1.039. The Commissioner rejected the request. However, the WCIRB was allowed to increase the expected loss costs. The result was a small cross subsidy from experience-rated risks to nonexperience-rated risks. In this filing, the WCIRB requests a change in the off-balance from 1.030 to 1.049.

We reject the selection of a 1.049. We substitute 1.040. The result, all other things being equal, is a 4.5% decrease in the indicated pure premium change. We also disallow the adjustment to the expected loss costs.

We have reviewed the calculations of the off-balance factor going back ten years. The factor has varied in a narrow range from 1.030 to 1.051. This confirms the commonly held belief that experience-rated risks do have better loss experience than nonexperience-rated and that this differential does not change dramatically from year to year. It is not clear that the variations from year to year are the result of anything more than random noise or cumulative rounding errors in the multistep calculation. We do not believe it is appropriate to peg the number at the low end of the historical range. We do believe it is appropriate to use a number in the middle of that range.

Claims Cost Benchmark Impact

As stated above, we have assumed that the medical pure premium trend is 3% per year, rather than the 5% assumed by the WCIRB. This 3% pure premium trend is composed of a 5% medical severity trend and a negative 2% claim frequency trend. We have accepted all other aspects of the WCIRB determination of the loss portion of the pure premium.

The result of this change in medical trend assumptions is to produce an on-level medical loss ratio of 57.9%, instead of the WCIRB provision of 61.4%. After adding in the WCIRB indemnity on-level loss ratio of 29.4%, which we accept, our analysis results in a total on-level loss ratio of 87.3%. This compares to the WCIRB ratio of 90.8%.

As also stated above, we allow a loss adjustment expense provision of 24.0%, instead of the 25.9% provision contained in the WCIRB amended filing.

Applying a loss adjustment expense multiplier of 1.240 to the total on-level loss ratio of 87.3%, we arrive at an on-level loss and loss adjustment expense ratio of 108.3%. The comparable WCIRB ratio is 114.3%.

Also as stated above, we allow an experience rating off-balance correction factor of 1.040, instead of the factor of 1.049 filed by the WCIRB. The allowed change in the off-balance factor is thus 1.010, as opposed to the 1.018 factor filed by the WCIRB.

Finally, the result of applying the change in off-balance factor of 1.010 to the on-level loss and loss adjustment expense ratio of 108.3% is an indicated increase in the Claims Cost Benchmark of +9.4%. We adopt this increase in lieu of the WCIRB's filed change of +16.0%.

Variability

There are numerous sources of variability in the experience and the analysis process that could cause the actual ultimate loss ratio for policy year 2009 to be different from what is estimated in the WCIRB filing or in our analysis of the filing. Differing assumptions about future paid and incurred development patterns, the impact of the reforms, and the need to adjust for changes in case reserve adequacy and claim settlement patterns can all influence both which actuarial loss estimation methods should be used and what results they produce.

The WCIRB presents the results of ten different methods in Appendix B of their original filing. A summary of the results of these methods is shown in Table 2 on page A:B-39. This summary shows indicated changes to the pure premium rate level ranging from a low of +4.4% to a high of +26.1%. We note that six of the ten methods produce indicated changes between +13.5% and +17.4%.

This discussion will not evaluate the relative merits of all of these methods as applied by the Bureau. It will instead concentrate on one key assumption: the prospective medical trend rate. This assumption is difficult to estimate and thus is subject to significant variability, as the following discussion will demonstrate. It is also an assumption that is central to the debate over whether or not the reforms have been successful at limiting future increases in medical costs.

In the post-reform era, both severity and frequency trend are difficult to estimate because implementation of the reforms in 2004 and 2005 have resulted in major decreases in both frequency and severity that have overwhelmed any underlying trends that may have been present. This leaves us with only accident years 2006 and 2007 from which to attempt to deduce what prospective trend in a post-reform environment might be. It would seem that in order for the data from these accident years to be useful for trending purposes, it would be necessary for the post-reform environment to have stabilized.

As mentioned previously in this Proposed Decision, the observed changes in the on-level pure premium ratios for medical losses were +12.2% from accident year 2005 to accident year 2006, and +6.2% from accident year 2006 to accident year 2007. The WCIRB presentation at the public hearing on this filing indicated that indemnity claim frequency decreased by 8.2% from 2005 to 2006, and by 5.4% from 2006 to 2007. These pure premium and frequency changes imply that medical severity must have increased by 22.3% from 2005 to 2006 and by 12.3% from 2006 to 2007.

The corresponding changes for indemnity losses are as follows. The on-level pure premium ratios increased by 8.6% from accident year 2005 to accident year 2006, and by 3.5% from accident year 2006 to accident year 2007. As stated above, indemnity claim frequency decreased by 8.2% from 2005 to 2006 and by 5.4% from 2006 to 2007, implying indemnity severity increases of 18.3% from 2005 to 2006 and 9.4% from 2006 to 2007.

We note that all of these changes are large, and that the changes from 2006 to 2007 are consistently significantly smaller than the changes from 2005 to 2006. These facts would seem to argue against the assumption that a stable post-reform environment has been reached, and would seem to argue in favor of the presence of a significant transitional effect being present in the data. This makes choosing a prospective trend assumption difficult.

It is also our understanding that the medical reforms were intended not only to eliminate unnecessary medical costs from the system, but also to put in place significant controls to limit medical cost increases in the future.

As previously explained, we believe our choice of a 3% per year medical pure premium trend, broken down into a 5% positive severity trend and a negative 2% claim frequency trend, is the most appropriate assumption. However, we have performed alternate calculations based on different trend assumptions. The results of these alternate calculations, and the possible circumstances under which they might prove to be more appropriate than our selection, are presented and discussed next.

On the low end of the assumptions we will discuss is a medical pure premium trend assumption of +1% per year. This is the assumption underlying the currently approved pure premium rates. This assumption could prove to be correct if medical severity increases by 3% per year and the frequency trend is -2% per year. This would require the bulk of the observed increases in medical severity and pure premium to be a temporary effect of the system seeking a steady state, and would require that the reforms be very effective in containing medical cost increases, both in per unit costs and in utilization of services. The severity trend could be greater if the long-term frequency trend proves to be a larger decrease than 2% per year. We believe the 1% medical pure premium trend assumption is an optimistic assumption.

A medical pure premium trend assumption of +1% per year, combined with a loss adjustment expense provision equivalent to our selected provision and a change in off-balance factor of +1.0%, produces an indicated change to the pure premium rate level of +6.0%.

The next medical pure premium trend assumption is our selected assumption of +3% per year. Our rationale for our selection has been explained in detail previously. The result of this and the loss adjustment expense and experience rating off-balance selections we made is an indicated increase of +9.4%.

The third medical pure premium trend assumption is the WCIRB's assumption of +5% per year. This assumes a claim frequency trend of -2% per year and a medical severity trend of +7% per year. This assumption compares to recent changes in medical cost components of the Consumer Price Index in the neighborhood of +4.5% per year. This implies that either California workers compensation medical costs per claim are expected to increase faster than general medical inflation, or that a significant increase in utilization of medical services is expected in the workers compensation system, or both expectations are present. This in turn would seem to imply that some erosion of the reforms is anticipated, and is being built into the WCIRB's assumptions. At the present time, we believe that to make such an assumption is premature and is a somewhat pessimistic assumption.

Of course, the result of the 5% medical trend assumption and the WCIRB loss adjustment expense and experience rating off-balance selections is an indicated increase of +16.4%, as presented in the amended filing. The result of this medical trend assumption and the loss adjustment expense and experience rating off-balance selections we made is an indicated increase of +12.8%.

Of course, there is the possibility that medical inflation will prove to be greater than 5% per year. Higher levels of medical inflation post-reform would indicate greater degrees of erosion of the effectiveness of the medical reforms, and would also seem to raise public policy questions about what aspects of the reforms are not working the way they were intended to, and whether any corrective legislation is needed.

We have examined two assumptions of higher medical inflation: +7% per year and +10% per year. We think these assumptions are pessimistic.

A medical pure premium trend assumption of +7% per year can be thought of as a +9% per year severity trend assumption and a -2% per year frequency trend assumption. This assumption, along with our selected loss adjustment expense assumptions and experience rating off-balance correction factor, results in an indicated increase to the pure premium rate level of +16.4%; the same as is indicated in the WCIRB filing.

Finally, a medical pure premium trend assumption of +10% per year can be thought of as a +12% per year severity trend assumption and a -2% per year frequency trend assumption. This would appear to represent a very substantial erosion of the medical reforms. This assumption, along with our selected loss adjustment expense assumptions and experience rating off-balance correction factor, results in an indicated increase to the pure premium rate level of +20.2%

Workers' Compensation Insurer Profitability

In our Proposed Decisions on previous WCIRB filings, we have commented on the fact that California workers compensation insurers have been very profitable in recent years as a result of the reform legislation, despite the substantial decreases that have been approved for the advisory pure premium rates. We have also commented that a major contributing factor to this excessive profitability has been the high level of insurer rates relative to the approved pure premium rates.

In the last Proposed Decision, which was for the January 1, 2008 filing, we pointed out that the average industry price level relative to the pure premium rate level was 147.1%, based on the latest data that was available at that time. We also pointed out that, due to the substantial amounts of investment income that are earned in the workers compensation line, it is possible for the average insurer to earn a reasonable rate of return at a combined ratio of 112% and a price level of 105% of the pure premium. Finally, we pointed out that the average price industry price level of 147.1% of the pure premium was more than 40% above the level that would produce a reasonable profit, and that this price level could be expected to produce an after-tax return on statutory surplus of more than 20%.

In the year that has passed since the last Proposed Decision was written, not much has changed. As of June 30, the average industry price level for policy year 2008 was 147.8%. It appears that the industry's average price level has been maintained at a very high level relative to the pure premium rate level, and that it can expect to continue to earn profits well above the level that constitutes a reasonable rate of return. It appears that competition has not yet become an effective regulator of rates for the California workers compensation insurance market, because insurers have been able to continue to overcharge California employers, their customers.

It also appears that, despite the WCIRB's filed request for an advisory pure premium rate increase of +16.0%, and our Proposed Decision granting an increase of +9.4%, there is no justification for insurers to increase their rates as a result of an increase to the pure premium rates, and in fact, insurer rates should be lowered. This is clear because current pricing levels are more than 40% above what would be needed to produce a reasonable rate of return if the pure premiums were adequate, and our Proposed Decision indicates that pure premiums only need to be increased by 9.4% to reach an adequate level. While we have pointed out in this Proposed Decision why we believe the WCIRB filing produces an indicated change that is higher than necessary, we would also point out that the WCIRB's filed increase of +16.0% is far less than the 40% excess margin currently built into the industry's pricing. We believe it should be clear that by any reasonable measure, industry pricing will still be higher than what is necessary to produce a reasonable profit if insurers take no action as a result of the approved change in pure premium rates.

OTHER MATTERS

Amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995

The WCIRB has proposed amendments to the California Uniform Statistical Reporting Plan—1995 to be effective on January 1, 2009 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2009. Those amendments include the following:

- Amend Part 2, *Policy Document Filing Requirements*, Section I, *General Instructions*, Rule 1, *Policies*, paragraph a, *New and Renewal Policies,* subparagraph (2)(d), to eliminate the optional Social Security Number reporting requirement for policyholders that do not have an FEIN, due to privacy concerns.
- Amend the minimum and maximum annual payroll for executive officers, partners, individual employers, and members of a limited liability company to increase the maximum from $92,300 to $94,900 and the minimum from $35,100 to $36,400, as well as to other payroll limitations relevant to specific classifications (e.g., athletic teams, entertainment classifications, taxicabs, etc.), to reflect wage inflation since the last time these amounts were amended January 1, 2008.
- Amend Part 3, *Standard Classification System,* Section VII, *Standard Classifications,* Rule 1, *Classification Section*, paragraph a, *Industry Groups,* to reflect the proposed establishment of *Metal Working Classifications* as an industry group.
- Amend the dual wage classifications noted below to increase the wage threshold by $1.00 to reflect wage inflation since the last time the wage thresholds were amended.
  Automatic Sprinkler Installation, Classifications 5185/5186
  Carpentry – private residences, Classifications 5645/5697
  Carpentry – other, Classifications 5403/5432
  Concrete or Cement Work, Classifications 5201/5205
  Electrical Wiring, Classifications 5190/5140
  Excavation/Grading Land/Land Leveling, Classifications 6218/6220
  Gas/Water Mains, Classifications 6315/6316

Glaziers, Classifications 5467/5470
Masonry, Classifications 5027/5028
Painting/Waterproofing, Classifications 5474/5482
Plastering or Stucco Work, Classifications 5484/5485
Roofing, Classifications 5552/5553
Sewer Construction, Classifications 6307/6308
Sheet Metal Work, Classifications 5538/5542
Steel Framing – light gauge – residential, Classifications 5630/5631
Steel Framing – light gauge – commercial, Classifications 5632/5633
Wallboard Application, Classifications 5446/5447

- Eliminate Classification 3076(5), *Cabinet or Enclosure Mfg. – metal,* as its constituents are more accurately described by other existing standard classifications.
- Eliminate Classification 2623(2), *Fur Mfg. – preparing skins,* due to inadequate statistical credibility.
- Eliminate Classification 2623(3), *Hide Processing or Preserving,* due to inadequate statistical credibility.
- Establish Classification 2586(3), *Hide or Fur Cleaning, Processing or Preserving,* as an alternate wording to Classification 2586(1), *Dry Cleaning or Dyeing – N.O.C.*
- Establish an industry group for *Metal Working Classifications.*
- Eliminate Classification 2106(1), Olive Handling – sorting, curing, packing and canning – including olive oil manufacturing, due to inadequate statistical credibility, and establish Classification 2111(2), Olive Handling – sorting, curing, packing and canning, to be an alternate wording to Classification 2111, Canneries – N.O.C.
- Amend Classification 0016, *Orchards – citrus and deciduous fruits,* to indicate that Classification 0016 applies to acreage devoted to olives.
- Eliminate Classification 2106(2), *Pickle Mfg.*, due to inadequate statistical credibility and establish Classification 2111(3), *Pickle Mfg.*, as an alternate wording to Classification 2111, *Canneries – N.O.C.*
- Eliminate Southern California Rapid Transit District Metro Rail Redline Project, Classification 6254, *Subway Construction – all operations*, due to inadequate statistical credibility.
- Eliminate Classification 2623(1), *Tanning,* due to inadequate statistical credibility.
- Amend Part 4, *Unit Statistical Report Filing Requirements,* Section I, *General Instructions*, Rule 8, *Excess Policies,* to eliminate the unit statistical report filing requirements for excess insurance policies since these requirements are obsolete.
- Amend Part 4, *Unit Statistical Report Filing Requirements,* Section II, *Definitions*, Rule 11, *Final Premium(s)*, to reflect the name of the Terrorism Risk Insurance Program Reauthorization Act of 2007 and to address the reporting requirements for the new provisions in Insurance Code Section 11760.1.
- Amend Part 4, *Unit Statistical Report Filing Requirements,* Section III, *Policy Information (Header)*, Rule 23, *Policy Type ID Codes (Policy Type ID),* to eliminate the unit statistical report filing requirements for excess insurance policies since these requirements are obsolete.
- Amend Part 4, *Unit Statistical Report Filing Requirements,* Section III, *Policy Information (Header)*, Rules 24 through 27, to facilitate the collection of deductible indicator information and to clarify its intended application.

- Amend Part 4, *Unit Statistical Report Filing Requirements,* Section V, *Loss Information,* Subsection B, *Loss Data Elements,* Rule 13, *Social Security Number (Social Security Number),* to eliminate the Social Security Number reporting requirement due to privacy concerns. This change is proposed to be effective with respect to claims required to be valued on or after January 1, 2009.
- Amend Appendix V, *Required Loss Fields for Particular Injury Types and Types of Claims,* to eliminate the Social Security Number reporting requirement due to privacy concerns. This change is proposed to be effective with respect to claims required to be valued on or after January 1, 2009.
- Various amendments for clarity and consistency.

Elimination of Social Security Number Reporting Requirements

Written comments were received objecting to the WCIRB's proposed change to eliminate Social Security Number reporting requirements. Those comments were from researchers or research organizations who are asking that the information be collected to aid in doing research in work injury and wage loss studies. All commentators acknowledge the privacy concerns the WCIRB may have in protecting individuals' Social Security Numbers but note that privacy concerns may be outweighed by the important public policy reasons for retaining this data.

The WCIRB's proposal to eliminate Social Security Number reporting fails to provide in the filing how this would affect research for which the WCIRB is currently involved or could be involved in the future. Additionally, other California state agencies, such as Employment Development Department and Department of Industrial Relations, rely upon data from the WCIRB to detect fraud in the workers' compensation, and there is not mention of whether this change would affect those efforts.

Given the concerns expressed in the comments received and the lack of additional information on the effect this change may have, the proposal to eliminate Social Security Number reporting requirements is rejected. The WCIRB is directed to review this issue with insurers, California state agencies that obtain data from the WCIRB, researchers, and any other interested parties and determine the consequences of this proposed change.

Olive Growing and Olive Oil Manufacturing

Testimony was received at hearing from representatives of the California Olive Oil Council objecting to the WCIRB's proposal to eliminate Classification 2106(1), *Olive Handling* and establish Classification 2111(2), *Olive Handling,* to be an alternate wording to Classification 2111, *Canneries – N.O.C.* There was no disagreement between the California Olive Oil Council and the WCIRB over elimination of Classification 2106(1), since it was no longer statistically credible. The California Olive Oil Council requested that its members be classified by analogy into Classification 2142(1), *Wineries* for olive oil production rather than Classification 4683(1), *Oil Mfg. or Refining—vegetable* and by analogy into Classification 0040, *Vineyards* rather than Classification 0016, *Orchards.*

The amendments requested by the WCIRB to eliminate Classification 2106 are not disputed and therefore are approved. The amendment to apply Classification 0016 to acreage devoted to olives, based upon the testimony of the parties, and the documentation provided by the WCIRB appear to be in line with the purpose of the Plan. Despite the Olive Oil Council's assertions that harvesting of dwarf olive trees is similar to harvesting grapevines, there is not enough evidence or documentation presented to support this. The Olive Oil Council's request to be reassigned by analogy to Classification 2142(1) for olive oil production is not before the Commissioner in the current filing and has not been given sufficient notice. At this point, the amendments presented by the WCIRB are approved based upon the documentation presented. The Olive Oil Council's member employers may appeal their classification by analogy through the Administrative Hearing Bureau of the Department of Insurance, but it is recommended that both parties work to resolve this issue informally.

Amendments to Reflect Wage Inflation

Testimony was provided during the hearing objecting to the amendments to adjust dual-wage classifications thresholds due to wage inflation. The information presented was documentation showing a drop in housing starts and a Contractors Dual Wage Class Code History. This information provided does not directly or indirectly support the contention that there is no wage inflation. Also, despite the assertion that increasing the wage thresholds will force non-union contractors to cheat and others to go to weaker alternative forms of insuring employees, no evidence was provided to support this.

The WCIRB provided a report regarding the needed increase in a report requested by its own Governing Committee dated September 5, 2008. The report provided by the WCIRB clearly shows wage inflation and the increase is adequate. Therefore, the amendments regarding changes due to wage inflation are approved.

Remaining Amendments

The remaining amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995 have been reviewed and, having received no objections regarding them, are approved as being reasonable and consistent with the purpose of this Plan.

Amendments to the Miscellaneous Regulations for the Recording and Reporting of Data

The WCIRB has proposed amendment to the Miscellaneous Regulations for the Recording and Reporting of Data to be effective on January 1, 2009 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2009. That amendment is:

- Amend Part 1, *General Provisions*, Section I, *Introduction*, Rule 2, *Effective Date*, to be consistent with the effective date of the California Workers' Compensation Uniform Statistical Reporting Plan—1995 for ease of reference.

This amendment having been reviewed and, having received no objections regarding it, is approved as being reasonable and consistent with the purpose of these Miscellaneous Regulations.

Amendments to the California Workers' Compensation Experience Rating Plan—1995

The WCIRB has proposed amendments to the California Experience Rating Plan—1995 to be effective on January 1, 2009 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2009. Those amendments include the following:

- Amend Section II, *Definitions*, Rule 2, *Base Premium*, to reflect the name of the Terrorism Risk Insurance Program Reauthorization Act of 2007.
- Amend Section III, *Eligibility and Experience Period*, Rule 1, *Eligibility Requirements for California Workers' Compensation Insurance*, to adjust the eligibility requirement from $14,300 to $17,300 to reflect wage inflation and to reflect the changes in the pure premium rates proposed in this filing.
- Amend Section V, *Application of Experience Modification*, Rule 6, *Experience Modification Corrections – Effective Dates*, to correct the citation to the Revisions of Losses rule.
- Amend Section VI, *Tabulation of Experience*, Rule 4, *Losses*, paragraph a, to correct the sequence of referenced paragraphs and rules, and paragraph l to reflect the name of the Terrorism Risk Insurance Program Reauthorization Act of 2007.
- Amend Section VI, *Tabulation of Experience*, Rule 11, *Terrorism Claims*, to reflect the name of the Terrorism Risk Insurance Program Reauthorization Act of 2007.
- Amend the expected loss rates and D-ratios shown in Table II, *Expected Loss Rates and Full Coverage D-Ratios*, to reflect the most current data available.

The amendments to the California Workers' Compensation Experience Rating Plan—1995 have been reviewed, and no objection to them has been received. These amendments are also reasonable and consistent with the Plan and are approved; however, we have concluded the change of the Pure Premium Rates should be +9.4%. Therefore, the WCIRB is directed to adjust the eligibility threshold to reflect the Insurance Commissioner's adopted Claims Cost Benchmark in order to maintain approximately the same volume of experience rated employers.

PROPOSED ORDER

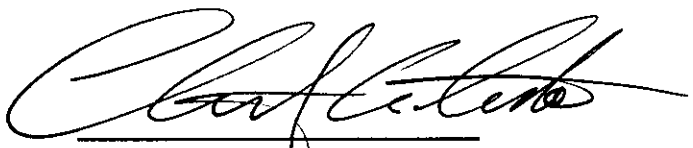
WHEREFORE, IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8 that the advisory workers' compensation pure premium rates filed by the WCIRB and Sections 2318.6, 2353.1 and 2354 of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein and in accordance with the Commissioner's adjustment to the Workers' Compensation Claims Cost Benchmark;

IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark adopted herein;

IT IS FURTHER ORDERED that these regulations shall be effective January 1, 2009 for all new and renewal policies with anniversary rating dates on or after that date.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on September 16, 2008, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

October 23, 2008



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